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# On Making and Breaking Contracts

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## MIDMIDCOURSE CORRECTIONS

### On Making and Breaking Contracts

Roger Bernhardt

Two different decisions from the (almost) same panel of the Second District Court of Appeal in Los Angeles came down within two days of each other with enough commonality to provoke me into writing one column covering both cases.

#### I. Was a Contract Really Made?

When a seller strings his potential buyer along, secretly hoping to be able to make a better deal with someone else, and then ultimately does not go through with the first one, what sort of wrong, if any, has he committed? That is the issue raised in *Simon v San Paolo U.S. Holding Co.* (2003) 113 CA4th 1137, 7 CR2d 367, reported at p 15. And because the amount of damages an aggrieved buyer is entitled to recover varies substantially according to one's conception of the wrong involved, that issue may turn out to have large monetary consequences.

In *Simon*, the putative buyer believed that a series of letters between the parties constituted a contract; and while there was substantial evidence to support his point of view (according to the court of appeal), the jury found that there was no enforceable contract between the parties, thus taking his breach of contract theory out of the case. However, instead of declaring that there was a contract, the jury found the seller bank guilty of fraud—apparently for telling the buyer a lot of lies during the negotiations—and held the bank liable for \$2.5 million in punitive damages. A second jury, re-ruling solely on the damages, awarded \$1.7 million, confirming the opinion that the seller must have behaved pretty badly.

A major problem with the amount of punitive damages was that it was supported by an award of only \$5000 for out-of-pocket losses—actual damages under CC §3343—or 1/340 as much as the punitives. That large a disparity can get a plaintiff into trouble under the Constitution as a denial of due process. Indeed, the United States Supreme Court had twice ordered the state courts to take a harder look at it.

The punitive award ultimately was upheld by the court of appeal on the ground that it was only about four times the buyer's "benefit of the bargain" loss (*i.e.*, \$400,000—the difference between the contract price of \$1.1 million and the buyer's estimated \$1.5 million market value for the property). Taking a somewhat novel line, the court held that the constitutional requirement of a reasonable relationship between punitives and actuals does not oblige the ratio to be limited by the damages allowed only by statute. Although "benefit of the bargain" loss is not included under CC §3343 (except in special cases), it can be used as the multiplier in calculating the propriety of punitive damages.

Since I am not an expert on the general rules of damages, I cannot say much about the multiplier argument. But what does surprise me, as a real estate matter, is why the buyer's actual damages were restricted to his out-of-pocket loss at all.

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### ***What if a party is defrauded out of a contract rather than into one?***

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Civil Code §3343(a) imposes its measure of damages on a party who was “defrauded in the purchase, sale or exchange of property.” I have always taken it for granted that this language referred to a buyer who was defrauded into purchasing property, not one who, as here, was defrauded out of purchasing it. The statute does not fit well in cases where there may have been fraud but no contract. I think that fraudulent but frustrated real estate deals fall more readily under our general fraud statutes—CC §§1709 and 3333.

It is not as if §3343 offers such a good measure of damages that plaintiffs ought to want to fit their claims under it. In hindsight, the legislature probably made a mistake when it adopted this section (a minority position nationally) in 1935, limiting damages to the “difference between the actual value of that with which the defrauded person parted and the actual value of that which he received” in real estate sales. This niggardly formula drives courts to make regular exceptions to it (as, for instance, in the fraudulent-broker cases, *e.g.*, *Salahutdin v Valley of Cal., Inc.* (1994) 24 CA4th 555, 29 CR2d 463, reported in 17 CEB RPLR 220 (July 1994)) and forced the legislature itself into adding amendments to soften its impact. In this case, it would have made a lot more sense for the jury to have been able to award a healthier measure of actual damages rather than having to convert punitive damages into a back-door substitute for them.

I wish I could come up with a drafting suggestion to handle this issue, but that is hard to propose when the problem is that the contract itself was never executed.

## **II. Was a Contract Properly Cancelled?**

What rights does one party have to get out of a sale contract when the other has failed to perform within her deadlines? According to Miller & Starr, the decisions on this issue “are not consistent.” 1 Miller & Starr, California Real Estate §1:162 (3d ed 2000). That is putting it mildly. I often cannot make head nor tail out of them, as happened again when I tried to comprehend *Galdjie v Darwish* (2003) 113 CA4th 1331, 7 CR2d 178, reported at p 25.

In *Galdjie*, the contract was supposed to have closed on April 9, but had not. The buyer got his loan commitment on May 12; however, on May 13 the seller cancelled, which led the buyer to sue her for specific performance. The buyer prevailed both at trial and on appeal, which I think was right, but the explanation given by the court casts more fog than sunshine on the issue of why the seller was not entitled to withdraw.

The court's opinion was to the effect that, but for the seller's conduct after April 9, which waived the deadline (and a tendency on her part to “manufacture evidence after the fact”), the contract would have automatically ended on that day. The court endorsed the statement from a 1992 decision that “where the parties have made time of the essence of the contract, at the expiration of time without tender by either party, both parties are discharged.” *Pittman v Canham* (1992) 2 CA4th 556, 560, 3 CR2d 340. While Miller & Starr do not think that is really the rule (nor do I), attorneys advising buyers should warn them that that can happen unless certain steps are taken.

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### *When does a contract run out of steam?*

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The starting point is a contract that includes a closing date which does not make time of the essence. (A more fundamental starting point might be a contract that does not even include a closing date, as in *House of Prayer v Evangelical Ass'n* (2003) 113 CA4th 48, 7 CR2d 24; but that occurs too rarely to take seriously.) Theoretically, the rules are the same whether it is the seller or the buyer who is late, but because buyers seem to need more time coming up with the money than do sellers to get their titles in order, let us suppose the buyer is late: If time is not made of the essence, it is treated as nonessential, meaning a buyer can pay late and his seller must accept it; since a court will always give the buyer reasonable time to perform, the seller might as well do the same. The best strategy for the seller to follow is, either before or when the specified day arrives, to set a new date, reasonably far away, and to inform her buyer that she will withdraw if he has not performed by then.

Does the presence of a “time of the essence” clause make such advice unnecessary? This opinion seems to say yes, disagreeing with the conclusion of Miller & Starr that the weight of authority is the other way. (Although I said the same back in 1967 when I wrote, “At best the [time is of the essence] clause seems to permit a party to insist on the contract date and, after timely tender and notice, to reject belated attempts at performance by the other.” California Real Property Sales Transactions §11.7 (Cal CEB 1967)). Under the Miller & Starr/Bernhardt reading of the cases, the contract terminates on that day *only if* (my italics) the seller has given the buyer an appropriate “drop dead” notice beforehand.

If the *Pittman/Galdjie* rule is correct, however, then a buyer goes out of contract if he does not have his down payment and loan funds in escrow by the original closing date. He is saved only if his seller said or did something to the contrary that is held to have effectively waived the closing date; mere tardiness would not be enough. Under that principle, a seller who wants out need only keep her mouth shut before the closing day and afterwards notify everybody that she has withdrawn. And a buyer, foreseeing delays, ought to do everything possible to get the seller’s written consent to an extension in advance.

Given the existence of inconsistent rules on this question, attorneys should counsel their clients on the basis of a worst-case scenario, advising a buyer that he risks being out of contract if he fails to either perform on time or get a provable extension giving him more time; and, in the case of a seller, instructing her to send a notice in advance when she wants to terminate even though there is a “time of the essence” clause.

A seller should also satisfy the possible additional requirement of performing, herself, all concurrent conditions fully and on time. She should be sure to deposit her deed in escrow before sending any termination notice. (It is so easy to actually send a deed to the escrow agent that it is unwise to tender that performance instead, thereby inviting a dispute over whether those acts really did amount to a satisfactory “tender,” a not very clear concept in the first place. The escrow instructions themselves always call for nondelivery of the deed to the buyer until he pays, which is protection enough.)

The presence of the standard escrow clause—providing that if escrow does not close on time, the escrow agent should close as soon as possible thereafter unless one of the parties had previously sent a written cancellation—may change some of this. Thus, if the “time-essence”

clause was held to make time absolutely essential, a court could say that the language in the escrow instructions nevertheless converted automatic discharge into discharge only after notice (although there was such a clause in *Galdjie*). If the clause was held to make time only potentially essential (*i.e.*, a warning notice still had to be sent), it would still generate questions about the interrelationship of the different notices that should go to the buyer and the escrow agent, and whether one can perform the function of the other. The additional presence in the contract of a clause authorizing the broker to extend the time for performance will create even more complications, its effect possibly depending on whether the broker was the seller's agent, a dual agent, or the buyer's agent.

Many other clauses that deal with the right to extend a contingency period rather than a performance deadline add further uncertainty to all of this. Lawyers can live under almost any set of rules, but in too many residential cases, buyers and sellers are on their own and without legal guidance. Since instructive legislation is unlikely, and it is even more unlikely to expect people to return to the old practice of having attorneys draft their sale and purchase contracts for them, I wish that publishers of legal forms would improve their products to give the parties clearer, and more, consequences to choose from rather than simply to leave the omnipresent "time is of the essence" clause as it is.